

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: McCarthy Analyst: Norman Catelli Bill Number: AB 2794
Related Bills: See Legislative History Telephone: 845-5117 Introduced Date: 02/20/2004
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Small Business Refiners Low Sulfur Diesel Fuel Credit/Depreciation Deduction

SUMMARY

This bill would provide a tax credit and an accelerated deduction to taxpayers that make expenditures to produce less polluting diesel fuel.

PURPOSE OF THE BILL

The purpose of this bill appears to be to use the tax code to change behavior to assist in reducing air pollution in California.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment, and by the specific terms of the bill:

- The credit provision would be operative for taxable years beginning on or after January 1, 2006, and
- The deduction provision would be operative for taxable years beginning on or after January 1, 2004.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

The U.S. Environmental Protection Agency (EPA) was formed in 1970 to coordinate federal efforts to develop knowledge about the environment and effectively insure the protection, development, and enhancement of the total environment itself. Also, in 1970 Congress amended the Clean Air Act to adopt new approaches to regulation such as national air quality standards and statutory deadlines for compliance. This law authorized the EPA to establish air quality standards to protect public health and the environment. Because pollution control problems often require special understanding of local industries, geography, housing patterns, etc., the EPA works closely with the states in administering the Clean Air Act.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	<u> X </u> PENDING

Department Director

Date

Gerald H. Goldberg

4/28/04

Governor Deukmejian created the California Environmental Protection Agency (Cal/EPA) in 1991 by Executive Order. Cal/EPA is the “umbrella” agency for six boards charged with the protection of human health and the environment and to assure the coordinated deployment of resources. The California Air Resources Board (CARB) is the constituent agency responsible for regulation of sources of air pollution through implementation and enforcement of EPA regulations and additional state requirements.

The Cal/EPA (through the CARB) works with the EPA in developing a state implementation plan that will explain how the state will do its job under the Clean Air Act.

The EPA has issued regulations that will require refiners to produce diesel fuel for use in highway vehicles with a sulfur content of no more than 15 parts per million (ppm), beginning June 1, 2006. This fuel is known as ultra low-sulfur diesel fuel (ULSD), or low sulfur diesel fuel. The CARB has issued regulations to conform to the federal requirements, and expanded the requirements to also include diesel fuel produced for off-highway use.

Existing federal and state laws generally provide that the basis of property is its cost. Property acquired in a tax-deferred exchange for other property has a basis equal to the basis of the property given up. The original basis of property must be adjusted for expenditures that are properly capitalized, such as improvements, and for other amounts, such as depreciation.

Under prior law, the Manufacturers’ Investment Tax Credit (MIC) would have been available to taxpayers making capital expenditures for refinery equipment. The MIC statute has been repealed by its own terms and ceased to be operative as of January 1, 2004, due to a reduction in manufacturing sector jobs.

Existing state and federal laws generally allow as a depreciation deduction a reasonable allowance for the exhaustion, wear, tear, and obsolescence of property used in a trade or business or property held for the production of income. A depreciation deduction is allowed for property that will provide economic benefits for more than one year. The depreciation deduction is generally allowed over a period of time approximating the property’s economic life. As an incentive for businesses to invest in property, occasionally an accelerated depreciation deduction is allowed. That is, a deduction is allowed at a faster rate than the decline in the property’s economic value would warrant.

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

THIS BILL

This bill would provide a credit in the amount of five cents for each gallon of low sulfur diesel fuel:

- Produced in California,
- For taxable years beginning on or after January 1, 2006,
- By a small business refiner, defined as,
 - A taxpayer that did not have more than 1,500 individuals engaged in refinery operations on any day during the taxable year, and
 - The daily refinery production of all of the taxpayer’s refinery operations for the one-year period ending on December 31, 2002, did not exceed 205,000 barrels.

The aggregate amount of the credit would be limited to 25% of the qualified capital costs paid or incurred during the applicable period to comply with the EPA low sulfur diesel fuel requirements. The applicable period would begin January 1, 2003, and extend to the earlier of:

- One year after the date the taxpayer must comply with the EPA regulations (there are waiver and hardship provisions that may delay the required date beyond June 1, 2006), or
- December 31, 2009.

The percentage limitation would be reduced for average daily production exceeding 155,000 barrels per day and eliminated when production reaches 205,000 barrels per day, meaning no credit is available.

This bill would provide that the Franchise Tax Board (FTB), in consultation with the EPA, must certify that the taxpayer's capital costs are necessary for compliance with the EPA requirements. The basis of any property that might be established by a qualified capital cost expenditure would be reduced by any credit allowed. The certification procedure provides that any credit allowed must be followed by an application for certification within 30 months after the first day of the taxable for which the credit is allowed. The process then requires FTB to consult with EPA and notify the taxpayer of the results within 60 days of receipt of the application. If notification is not made within the timeframe, the taxpayer may presume the certification to be issued. The bill also provides that the statute of limitations (SOL) for issuing a deficiency attributable to the credit will be three years after the due date of the certification.

This bill would allow any unused credit to be carried over until exhausted.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

Typically, credits involving areas for which the department does not possess expertise are certified by another agency or agencies that possess the relevant expertise. The CARB is the department officially responsible for the implementation of the low sulfur diesel fuel regulations in California. This bill does not provide a role for the CARB in the administration of this credit and deduction, although that is the department with the responsibility, knowledge, and expertise to ensure the bill's objectives are met. Certification by the CARB would eliminate many procedural questions that are raised by the bill's certification procedure. For example, what happens if FTB and EPA do not agree on certification? If certification is denied, how is the credit recaptured? Does this new SOL replace or supplement existing SOLs for the issuance of deficiencies? The certification language would specify the responsibilities of both the certifying agency and the taxpayer. The certification should take place before the credit is allowed.

The term "qualified capital costs" may be broadly interpreted to include all expenditures to modernize the refinery. If it is the author's intent to limit this credit and deduction to expenditures directly related to meeting the EPA's low sulfur diesel fuel requirements, the term needs to be more narrowly defined.

This bill does not limit the number of years for the carryover period. The department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits typically are exhausted within eight years of being earned.

TECHNICAL CONSIDERATIONS

The introduction states “An act to add...Section(s) ...236~~62~~, and...” Page 5, line 36, however states: SEC. 3. Section 236~~22~~ is added ... These references should be the same.

Page 9, line 10, refers to Section 20622, but should refer to 236~~22~~ or 236~~62~~.

Page 9, line 11, refers to Section 17053.62, normally the correct reference would be 23662 or 23662.

It is clear that the low sulfur diesel fuel must be produced in California, but it would be helpful to clarify that “qualified costs” must be incurred for facilities located in California.

The definition of a “small business refiner” is similar to, but different from, the definition of a “small refinery “ contained in the EPA regulations related to the low sulfur diesel fuel requirements (40 CFR Ch.I-Part 80). Differing definitions may cause taxpayer confusion.

The language in subdivision (g) of the relevant sections addresses cooperative organizations pursuant to Internal Revenue Code Sections 1381(a) and 1382(d). The California Personal Income Tax Law does not conform to these federal provisions or have similar provisions. The California Corporation Tax Law does not conform to these federal provisions, but does have provisions recognizing agricultural and other cooperatives. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

LEGISLATIVE HISTORY

AB 1998 (Dutton, 2003-2004) would reinstate the previous MIC for taxable years beginning on or after January 1, 2005, and extend the MIC to activities related to electric service (power generation, transmission, or distribution). AB 1998 is scheduled to be heard in the Assembly Revenue and Taxation Committee on May 3, 2004.

AB 2070 (Houston, 2003-2004) would reinstate the previous MIC for taxable years beginning on or after January 1, 2005. AB 2070 is scheduled to be heard in the Assembly Revenue and Taxation Committee on May 3, 2004.

AB 2076 (Dutton, 2003-2004) would reinstate the previous MIC only for electric service activities for taxable years beginning on or after January 1, 2004. AB 2076 is in the Assembly Revenue and Taxation Committee.

SB 1295 (Morrow, 2003-2004) would reinstate the MIC for taxable years beginning on or after January 1, 2004, and increase the rate of credit from 6% to 8%. SB 1295 is in the Senate Revenue and Taxation Committee.

SB 671 (Alquist, Ch. 881, Stats. 1993) added the MIC to the Revenue and Taxation Code.

SB 676 (Alquist, Ch. 751, Stats. 1994) made clarifying changes to the MIC, and added provisions allowing the credit for leased property. SB 676 specifically limited the MIC to the lessee.

OTHER STATES' INFORMATION

The states surveyed include *Illinois*, *Massachusetts*, *Michigan*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. The survey was limited to income or franchise tax benefits related to manufacturing equipment.

Illinois provides a replacement tax investment credit equal to 0.5% of the basis of qualified property placed in service during the tax year (from July 1, 1984 to January 1, 2004), used by a taxpayer primarily engaged in manufacturing, retailing, coal mining, or fluorite mining.

Massachusetts provides a 3% credit based on the cost of qualified property used for manufacturing, farming, fishing, or research and development.

Michigan provides a certified, graduated investment tax credit based on adjusted gross receipts of a firm. The credit is a percentage (0.85% to 2.3%) of the net costs of qualifying tangible, depreciable assets located in Michigan.

New York provides an investment tax credit to manufacturers for certain depreciable equipment or buildings. The credit is 5% of up to \$350 million of qualified expenditures and 4% for qualified expenditures in excess of \$350 million. Certified pollution control, industrial waste treatment, and acid rain control facilities also qualify for this credit. Research and development property may qualify for an optional rate of 9%.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved but are anticipated to be significant.

This bill would require a calculation for the credit that would require a new form or worksheet to be developed. As a result, this bill would impact the department's printing, processing, and storage costs for tax returns. The additional costs have not been determined at this time. If the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this measure, under the assumptions discussed below, is estimated to be as follows:

Revenue Impact of AB 2794 (2/20/2004) Enactment Assumed After June 30, 2004 \$ Millions					
	2004-5	2005-6	2006-7	2007-8	2008-9
Expensing Provision	-1.0 loss	Negligible	+0.6	+0.5	+0.3
Credit Provision	-	-3.0 loss	-13.0 loss	-9.0 loss	-4.0 loss
Total	-1.0 loss	-3.0 loss	-12.4 loss	-8.5 loss	-3.7 loss

This analysis assumes that the production limitation applies to all facilities of a combined group of taxpayers. This analysis does not account for changes in employment, personal income, or gross state product that could result from this measure.

This analysis is based on a forecast of \$132 million of qualified expenditures by qualified taxpayers. Therefore, the allowable credit amount (25%) would be \$33 million, which was applied to fiscal years through the use of a micro simulation model of the California economy that forecasts taxable income and credit utilization. The balance of the expenditures (\$99 million) were adjusted for the timing difference of allowing the deduction over a two year period rather than the normal ten year period for expenditures of this type. An average income tax rate and California apportionment factor was then applied to determine the net revenue effect.

Expensing 75% of the qualified capital costs would be in lieu of depreciating these expenditures. The slight revenue gain after 2005-6 is due to the unavailability of a depreciation deduction after taking an expense deduction for those expenditures in prior years.

Various calculations and projections were made based on data sources and assumptions stated below. It was projected that the eligible capital costs the tax credit in 2006 would in general be based on the 25% of capital cost limitation rather than on 5¢ per gallon.

Revenue Discussion

The revenue impact of this proposal was estimated using the following sources:

1. Data on production capacity for California small business refiners from California Energy Commission.
2. Estimates of capital costs to modify existing refineries to produce ULSD from CARB and the U.S. Energy Information Administration (EIA).
3. Data on total California diesel fuel production from EIA.
4. Company-level data on tax liabilities, state net incomes, and apportionment factors.
5. Contacts with industry experts.

The following assumptions were made in the estimation of the revenue impact:

- Only the refineries that are currently producing diesel fuel would produce ULSD in the future.
- By 2006 all refineries would produce ULSD.
- All the required capital investment would be undertaken prior to 2006.
- The qualified small business refiner is the one for which the sum of average domestic refinery runs for all facilities combined did not exceed 205,000 barrels per day. If the language of the proposal is interpreted to mean that the 205,000 barrels-per-day limit applies to individual facilities regardless of affiliation, the revenue impact of the proposal would be significantly larger.

POLICY CONCERNS

This bill would allow tax credits for expenditures for the production of low sulfur diesel fuel, expenditures that are already required by existing state and federal laws or regulations.

This bill allows the accelerated depreciation deduction in the taxable year in which the equipment is purchased, which may be earlier than the taxable year in which the equipment is actually placed in service (i.e., used) in California. Most deductions involving the acquisition and subsequent use of an item of property require the property to be placed in service. It is possible that a taxpayer could purchase the equipment, claim the credit, and resell the equipment to a third party that may also claim the credit. If this bill were to require that the equipment be placed in service in California, with an appropriate recapture provision to ensure continued operation in California for a specified (recapture) period, this potential problem would be avoided. The recapture provision would require the taxpayer to use the equipment for a certain length of time in this state or add all or some portion of the credit amount back to the tax liability.

This bill does not limit the amount of the credit that may be taken. To control the total revenue loss, credits are sometimes limited either on a per-project or per-taxpayer basis, or alternatively on the basis of total credits for the entire year for all taxpayers. The latter would require a state agency to certify and approve the bill's criteria as discussed under "Implementation Considerations" in this analysis.

This bill would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

Additionally, the EPA and CARB have programs available to assist small refiners in meeting the requirements. A coordination of all these resources may be beneficial to taxpayers and the state.

This new credit would require an adjustment to reduce basis in order to eliminate the double benefit of receiving both the credit and the expense deduction or depreciation deduction. However, this adjustment would create a state and federal difference, which is contrary to the state's general federal conformity policy.

Although the bill has an implicit sunset date based on the credit and deduction requirements, it may be advisable to include a specific repeal date.

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